

FINANCIAL CRISES: NINE LESSONS FROM EAST ASIA

Masahiro Kawai
University of Tokyo

Richard Newfarmer
World Bank

and

Sergio L. Schmukler
World Bank

INTRODUCTION

As private capital flows to developing countries surged in the 1990s, financial crises in emerging market economies have occurred with disturbing and increasing regularity. The sudden cessation and then reversal of capital flows to Mexico in 1994 caused the first tremors in the global economy, leading to the devaluation of the peso and deep recession, with direct spillovers into Argentina (the Tequila crisis). The major financial crisis in East Asia soon followed. The currency crisis in Thailand was rapidly transmitted to Indonesia, Malaysia, the Philippines, and Korea, and its impact ramified throughout the global economy. Since then, the emerging markets have experienced a steady series of aftershocks: in 1998 and 1999 capital flow reversals induced currency devaluations in Russia (August 1998) and Brazil (January 1999), and most recently recession, devaluation, and default in Argentina (2002), as well as recessions and payments problems in Uruguay and Ecuador (2002). Though the region has since recovered, East Asia's crisis remains the most severe in its depth and regional breadth.

In the years since it occurred, attempts to understand the East Asia crisis have provided a treasure trove of studies that illuminate various causes of financial crises. Though they differ in emphasis, an emerging consensus points to four mounting vulnerabilities in Thailand, Indonesia, Korea, and Malaysia.¹ First, the global economy spawned an unprecedentedly large surge in private capital flows in the 1990s, especially short-term flows, as deregulated banks in the rich countries scanned the globe for higher return opportunities, and East Asia looked particularly attractive with its low debt ratios, rapid growth, and stable exchange rates [World Bank, 2000b; 2001].

Sergio Schmukler: Development Research Group, The World Bank, 1818 H Street NW, Washington, D.C., 20433. E-mail: sschmukler@worldbank.org.

Second, macroeconomic policies in East Asia took advantage of this boom to facilitate large inflows of short-term, unhedged, foreign currency-denominated capital, fueling a domestic credit boom and even more rapid growth [World Bank, 2000a]. Third, many countries had liberalized their domestic financial sectors, but without sufficient regulation, and domestic banks supplied cheap capital to already highly leveraged corporations that took on easily available credit [Claessens, Djankov, and Lang, 1998]. Finally, politics, at first stable, introduced new risks that culminated in important changes at precisely the time when internal financial vulnerabilities were becoming worrisome [Haggard, 2000]. A combination of the first three factors led to overinvestment in domestic nontradable sectors—manifested as property price bubbles, especially in Thailand and Malaysia—and in selected inefficient manufacturing sectors—as was done by Indonesian group firms and Korean *chaebol* firms. Availability of cheap capital that was poorly intermediated through weakly supervised and governed financial institutions allowed corporations to add debt to their already highly leveraged balance sheets. As one country entered crisis, investors examined other countries for similarities and shifted portfolios, or were compelled to do so as the first country's demise raised risk on the whole class of investment, producing contagion [Calvo, 1998; Dornbusch, Park, and Claessens, 2000].² The fourth factor aggravated this process. The devaluation of the Thai baht in July 1997 triggered a gathering panic among investors that led to probably one of the most massive outflows of capital from any developing region in human history. More than US\$100 billion were withdrawn from the Association of Southeast Asian Nations (ASEAN) countries and Korea in the space of only 18 months after the Thai baht devaluation.

The East Asian experience has left in its wake an abundance of new research that allows us not only to understand the nature of financial crises better, but to begin to draw out generalized lessons for policy, associated trade-offs, and constraints to ready implementation. In this paper, we summarize the literature on what we believe are nine interrelated and general policy lessons from the East Asian crisis and we analyze the difficulties encountered in establishing those policies. Abstracting general lessons is not easy because each crisis differs in its timing, its specific economic and political circumstances, its global economic conditions, and its associated policy causes and responses. This challenge compels us to raise the discussion to a higher level of generality than would satisfy policy makers confronting a crisis, but it will tease out the important variables, and indicate the literature and policy directions that they would have to consider. We divide the lessons into four sections for examination: preventing crises, managing crises, resolving the systemic consequences of crises, and constructing a new international financial architecture, including a regional focus. Table 1 presents a schematic overview.

TABLE 1
Summary of Nine Policy Lessons

Objective	National Measures Improve mechanisms for crisis prevention, management and resolution at the national level.	Global Measures Improve mechanisms for crisis prevention, management and resolution at the global level.	Regional Measures <i>9. Improve mechanisms for crisis prevention, management and resolution at the regional level in a way consistent with the global framework.</i>
Preventing or reducing the risk of crises	<p>1. Avoid large current account deficits financed through short-term, unhedged capital inflows.</p> <ul style="list-style-type: none"> · Secure adequate foreign exchange reserves. · Maintain sound fiscal & monetary policy. · Adopt a viable exchange rate regime. · Establish orderly capital account liberalization. <p>2. Aggressively regulate and supervise financial systems to ensure that financial institutions manage risks prudently.</p> <ul style="list-style-type: none"> · Strengthen regulatory & supervisory frameworks over financial institutions. · Allow prudential regulation as financial safeguards and cushions. · Improve information transparency. · Introduce limited deposit insurance. <p>3. Erect an incentive structure for sound corporate finance to avoid high leverage and excessive reliance on foreign borrowing.</p> <ul style="list-style-type: none"> · Establish good corporate governance. · Introduce greater competition to product, factor & financial markets. · Develop capital market-based finance. · Better information disclosure. 	<ul style="list-style-type: none"> · Strengthen IMF surveillance. · Tighten regulations over financial institutions that lend to highly leveraged institutions. 	<ul style="list-style-type: none"> · Strengthen regional policy dialogue and surveillance. · Coordinate monetary and exchange rate policy.
Managing crises	<p>4. Mobilize timely external liquidity of sufficient magnitude.</p> <ul style="list-style-type: none"> · Restore market confidence · Reduce moral hazard problems. <p>5. Do not adopt a one-size-fits-all prescription for monetary and fiscal policy.</p> <ul style="list-style-type: none"> · Adopt appropriate monetary and fiscal policy contingent on the specific conditions of the economy. 	<ul style="list-style-type: none"> · Strengthen IMF liquidity support. 	<ul style="list-style-type: none"> · Establish a regional facility for liquidity support. · Strengthen regional capacity to formulate needed adjustment policies.

TABLE 1
Summary of Nine Policy Lessons—Continued

Objective	National Measures	Global Measures	Regional Measures
Managing crises— (continued)	6. Bail-in private international investors. · Impose official standstills. · In extreme cases, allow involuntary private sector involvement.	· Establish international rules of the game through private sector involvement.	· Involve international creditors from outside the region.
Resolving the systemic consequences of crises	7. Move swiftly to establish resolution mechanisms for impaired assets and liabilities of banks and corporations. · Establish procedures for bank exits, recapitalization, and rehabilitation. · Establish frameworks for corporate insolvencies & workouts. 8. Cushion the effects of crises on low-income groups through social policies to ameliorate the inevitable social tensions. · Strengthen social safety nets to mitigate social consequences of crises.	· Establish international frameworks for private sector involvement in external debt resolution. · Finance the activity through the MDBs and bilateral donors.	· Finance regional programs to help resolve the systemic impact of crises through the regional MDBs and bilateral donors

PREVENTING CRISES

In a world of free capital mobility, speculative attacks on currencies can occur whenever confidence is lost. Moreover, a currency crisis in a foreign country can rapidly trigger a crisis at home. Crisis prevention attempts to lower the probability of having a crisis and to reduce *ex ante* the risk factors.

In retrospect, three factors combined to increase East Asia's vulnerability: the rise in external private indebtedness—mainly short-term and unhedged; the asset-liability mismatch in the financial system together with its low return intermediation; and the highly leveraged financial position of corporations. The first factor is related to macroeconomic policy, the second to financial sector policy, and the third to corporate governance. Each area provides a lesson for the future.

Lesson 1: Avoid large current account deficits financed through short-term, unhedged private capital inflows.

Several policy domains affect the net external liability position of a country and its propensity toward crises. In East Asia, it is instructive to review several interrelated macroeconomic policies: foreign exchange reserves, fiscal and monetary policy, exchange rate policy, and policy toward the capital account.

Foreign Exchange Reserve Policy. As capital movements have become larger, foreign exchange reserves have become an increasingly important line of defense. The adequacy of foreign exchange reserves can no longer be measured by their coverage of imports, but by the magnitude of potential capital outflows. Guidotti [1999]

concludes that reserves should equal the amount of capital contractually due in the coming year. But reserves should arguably be larger if current account deficits are large (for example, more than 2 percent of GDP), if the exchange rate is fixed and hence more vulnerable to shocks, or if the economy has a historical tendency toward instability (for example, because of commodity dependence and chronic terms of trade shocks [World Bank, 2000b]). Needless to say, the optimal amount of reserves must also be judged against the opportunity cost of carrying them.

Fiscal and Monetary Policy. In the case of the affected East Asian economies, fiscal policy was disciplined and monetary policy was non-inflationary until the mid-1990s. But in Thailand, fiscal policy became pro-cyclical in an attempt to stave off a slowdown in the quarters immediately preceding the crisis. The country continued to face mounting current account deficits in 1996, investor perceptions began to shift against local assets, and capital inflows began to attenuate. Authorities tried to extend the growth cycle, but fiscal stimulus, instead of increasing output, was transmitted mainly to the balance of payments through rising imports and more outflows in the capital account, worsening the external balance and pressuring the peg (World Bank [2000a]).

With the benefit of hindsight, we can now conclude that to reduce vulnerabilities and the probability of crisis in Thailand, macroeconomic policy in 1996 should have reigned in aggregated demand, avoided excessive credit expansion in the domestic economy, and curtailed the excessive external reliance on foreign savings. This would have slowed the expansion, but reduced the extent of real effective overvaluation and the current account deficit, and slowed the buildup of short-term external debt relative to foreign exchange reserves.³

Monetary policy should have maintained consistency with the *de facto* pegged exchange rate arrangement in the pre-crisis period. This policy would have implied lower credit growth and higher interest rates when capital inflows began to taper off. Restrictive monetary policy in the period immediately preceding the crisis, especially if coupled with a neutral or even contractionary fiscal stance, might have preempted the currency run that eventually came.

Exchange Rate Policy. Countries with large current account deficits are dependent on capital inflows to maintain their external balance. If investors lose confidence in a currency value, however, capital inflows can stop abruptly and capital outflows can take place in massive amounts. In the face of sudden shocks to capital flows and currency markets, the country may be forced to adopt a contractionary monetary policy and to curtail the economic activity sustained by capital inflows. It is therefore important to maintain a viable exchange rate regime, with a consistent monetary and fiscal policy framework in order to deter speculative attacks and thus avoid “sudden stops” [Calvo, 1998; Kawai, 1999]. A viable exchange rate regime has sufficient flexibility to adjust to external shocks, which is typically obtained with some degree of exchange rate flexibility or with flexibility in domestic prices, including wages.⁴

In the case of East Asia, several economies had maintained stable exchange rates *vis-à-vis* the U.S. dollar until the crisis. For example, Thailand had its baht pegged to a basket of currencies, with the U.S. dollar having a dominant weight. Other countries also had their currencies *de facto* pegged to the dollar. This was widely perceived

as an official guarantee to minimize currency risk and to encourage trade, foreign direct investment (FDI), and other capital inflows. U.S. dollar appreciation since 1995, against currencies of other major industrialized countries, particularly against the Japanese yen, may have contributed to a perception of unsustainable exchange rates in East Asia.⁵

Capital Account Liberalization. The East Asian crisis has shown that capital account liberalization that provides financial institutions with access to cheap foreign savings can set the stage for asset-liability mismatches. Unfettered capital mobility may be dangerous if the regulatory and supervisory policy framework is weak and if domestic financial and corporate sectors cannot manage risks prudently.

Some countries have adopted explicit capital controls as a way to isolate the domestic economy from the volatility of global financial cycles [Calvo and Reinhart, 2000; Kawai, 1998; World Bank, 2000b]. Restrictions on capital inflows usually have the objective of curtailing excessive short-term inflows through taxation of foreign loans with a short maturity—usually less than 12 months;⁶ higher reserve or liquidity requirements [Dooley, 1996; Reinhart and Reinhart, 1999]; or imposition of outright controls. The case of the Chilean controls received the most attention in the literature and among policy makers. The controls required that, to bring short-term capital to the country, a certain proportion of the funds had to be put aside in the form of nonremunerative reserves, thereby raising the cost of borrowing short-term foreign capital. As discussed below, a similar type of inflow control can be exercised as part of prudential regulation over banks and corporations, and these regulations can have the same effect as the capital controls.

Pitfalls. It has not been easy to implement these policies. Regarding foreign exchange reserves, it is difficult to calculate the right amount of reserves needed. It is fair to say that policy makers, including international financial institutions, have tended to underestimate the amount needed to cope with external vulnerability. Also, whenever the volume of reserves is perceived to be high, there are large pressures to use them for many urgent needs, rather than allow them to accumulate to withstand eventual speculative attacks.

With respect to monetary and fiscal policy, though it would be ideal to follow counter-cyclical policies, there are several obstacles to doing so. First, it is not a straightforward task to determine in which part of the cycle an economy is. Second, there are few political-economy incentives to make adjustment during boom years. One way to achieve these policies is through a predetermined set of rules that bind policy makers—though these rules can always be changed.

The effect of capital controls seems to diminish progressively as investors learn of ways to circumvent the legislation, requiring successive efforts at expanding the comprehensiveness of the control regime. The ways in which controls are circumvented and become ineffective over time have been documented in a series of studies [Edwards, 1999; Gallego, Hernandez, and Schmidt-Hebbel, 1999; Edison and Reinhart, 2001; Kaminsky and Schmukler, 2001].

Lesson 2: Aggressively regulate and supervise financial systems to ensure that banks manage risks prudently.

In the run-up to the crisis, East Asian banks developed large asset-liability mismatches—unhedged foreign exchange borrowings invested in nontradable sectors and short-term funds lent long into property—all of which left the banks vulnerable to exchange depreciations and to interest rate surges. This vulnerability reflected the fact that domestic financial systems were not well-regulated or governed when capital account liberalization was accelerated in the first half of the 1990s. Regulatory and supervisory frameworks over financial institutions were weak in risk-management and the capital base—together with loan classification and loan loss provisions. Moral hazard was created because of explicit or implicit government guarantees to individual financial institutions [Goldstein and Turner, 1996; Demirguc-Kunt and Detragiache, 1998; Eichengreen and Rose, 2001].

Having a resilient and robust financial sector is key to avoiding crises. First, as a preventive measure, countries with resilient and robust financial sectors will probably suffer less from contagion. Second, these countries will have more flexibility to cope with external shocks and to take corrective measures during a crisis. Countries with a solvent banking sector and low corporate leverage ratios will be able to raise interest rates to contain speculative currency attacks.⁷

Policies that can achieve this financial structure include: prudential regulation of asset-liability mismatches and portfolio and loan standards that adhere to internationally accepted norms; capital adequacy regulations that, at a minimum, match those that are required under Basle standards; clear governance rules to prevent insider and group lending not subject to loan evaluation and creditworthiness and standards; transparency for investors and depositors through mandatory public disclosure of audited financial statements; and, finally, deposit insurance limited to a minimal share of private liabilities to bound government contingent liabilities in event of crisis, and share risk with investors and depositors (see, for example, Stiglitz and Bhattacharya [2000]).⁸

At least two clarifications are warranted with respect to these policies. First, a prudential regulation can be used as a complement to capital controls, with the government requiring commercial banks to put aside a certain proportion of the short-term funds borrowed abroad in the form of reserves. The idea behind this type of controls is to lengthen the maturity structure of capital inflows by making short-term borrowing from abroad more expensive than long-term borrowing, in light of the view that short-term capital inflows can be risky. Second, the limited nature of the deposit insurance is intended to reduce moral hazard. If a commercial bank makes risky investments, then depositors may shift their deposits away from such banks to less risky banks, thereby disciplining the behavior of both commercial banks and depositors. Deposit insurance can limit the disciplinary effect of deposit shifts, as depositors do not need to respond fully to bank risk taking. A limited, as opposed to a broad, deposit insurance would circumscribe the potential reduction of market discipline.

Pitfalls. As a measure to manage capital flows, prudential regulation can be less distortionary and less subject to evasion than other tools like capital controls, but it also tends to be less comprehensive. As discussed below, prudential regulation over financial institutions does not prevent direct corporate borrowing of the type prevalent in Indonesia, but it does wall off the financial sector from the largest contingent risk to the treasury. Another potential difficulty of supervising the financial system is that developing countries do not usually have the expertise or enough resources to hire good supervisors [Barth, Caprio, and Levine, 2002]. To complement the oversight of the financial system by regulators and supervisors, countries can use markets by encouraging market discipline and other market participants like rating agencies [World Bank, 2001]. Market discipline requires access and transparency of information, however, such that the problems of asymmetric information are minimized. Perhaps, more effective surveillance through the IMF's Article IV consultation might help in achieving more transparency. The issue of transparency is also crucial for the corporate sector as discussed in the next lesson.

Prudential regulation over financial institutions also means costs, including less comprehensiveness without covering direct corporate borrowing; higher domestic short-term interest rates; and possible evasion of the controls if imposed for a long period of time. Regarding deposit insurance, though government can set up limited deposit insurance schemes *ex ante*, such schemes are seldom credible in developing countries due to the systemic nature of crises and due to the limited funds available to back them [Martinez Peria and Schmukler, 2001].

Lesson 3: Erect an incentive structure for sound corporate finance to avoid high leverage ratios and excessive reliance on foreign borrowing.

The experience in East Asia shows that highly leveraged and vulnerable corporate sectors were a key determinant of the depth of the crisis. As economic growth remained high, it concealed the negative effects of inefficient resource allocation while insider financial flows without due diligence did not create problems. But as the economies went into crisis, the problems associated with bad corporate governance were exposed. Currency devaluation suddenly inflated the size of external debt—measured in terms of the domestic currency—and debt service obligations and high interest rates also sharply increased domestic debt service obligations of the corporations, driving the domestic corporations into financial distress. These vulnerabilities affected the banks with exposure to the corporations. This created a liquidity crunch and deepened the recessionary pressures, which in turn hurt the corporate sector even more. The presence of a disciplined corporate sector with sustainable debt-to-equity ratios is thus important to weathering exchange rate and interest rate shocks. Several building blocks are essential to an incentive framework for sound corporate finance: clear rules of corporate governance, improved competition policies, deep corporate capital markets, and information transparency.

Corporate Governance. New rules of corporate governance must be established to reduce conglomerate structures, that is, concentrated holdings in a few families, corporate groups—like *chaebols*—and amalgamated banks, which create a complex

web of insider financial flows with minimal due diligence in lending and inadequate corporate oversight. Rules that require good accounting, auditing, and information disclosure protect minority shareholders and strengthen creditor rights, which can prevent the buildup of huge debt positions on narrow capital positions.

Competition Policy. Improvement of competition policies both in capital markets and in product/factor markets can also strengthen corporate discipline. In addition, creating and enforcing domestic bankruptcy legislations would strengthen corporate governance. Though greater competition does not completely eliminate corporate misbehavior—as evidenced by recent scandals in the U.S., beginning with Enron—it calls for greater efficiency and better resource allocation due to market pressure for firm survival, thus limiting the extent of misbehavior.

Corporate Equity and Bond Markets. One of the gaps in the financing and governance regimes in crisis-affected East Asia was the stunted development of corporate equity and bond markets. Equity markets are an important source of capital, but the reluctance of family owners and insiders to dilute their ownership share often fed their decision to seek easy bank financing, often from banks they controlled. At the same time, the absence of adequate disclosure and other protections for minority shareholders has led many investors to eschew investment in their domestic markets. Similarly, bond markets provide constant and instant market evaluation of debt value and, hence, provide an essential signaling function to financial investors. In the absence of bond markets, however, banks had no reason to market their loans to corporations, and corporations had one less reason to alter their performance to become more efficient. Corporations could thus develop unsustainable, high debt-equity ratios. The policies that might help develop corporate equity and bond markets include: regulatory capacity to implement full disclosure and contract enforcement, protection of minority shareholder rights and bondholder rights, and neutral tax policies to eliminate any bias in favor of bank finance over capital market finance.

Information Disclosure. Much of the overlending prior to the East Asian crisis might not have occurred had international lenders correctly appraised the actual balance sheets of borrowing corporations. Many investors tried to undertake due diligence, but without accurate information. Because it was costly to gather, many investors did not spend resources to obtain valuable information, relied on superficial reviews by others, and simply followed the herd. Better information disclosure can help mitigate this problem, particularly among relatively uninformed international investors, and can guide them to efficient investment decisions, if sufficient incentives are created to use such information.

Pitfalls. Establishing policies for obtaining adequate corporate governance, fostering competition, developing capital markets, and encouraging information disclosure might be more difficult than it sounds. As Rajan and Zingales [2003] argue, well-established firms may oppose the development of the financial system, as it breeds competition and reduces their advantage. Moreover, in the post-Enron period, it is now clear that putting a reporting law in place, adopting accounting and auditing

standards with international “best practices,” and having competitive accounting/auditing industries would not be enough. Rather, policy makers have to ensure adequate oversight and enforcement and pay due attention to the incentives governing both the auditors and the firms—and even these may not be sufficient to guarantee full information disclosure. Finally, capital market-based finance in developing countries can lead to a short-term financial structure, which might reduce productive investment. Still, many emerging market economies are heavily bank based and short-termism can also occur in a bank-based system.

MANAGING CRISES

Once a country is affected by a crisis, its policy objective must focus on preventing it from developing into a more serious economic and social crisis with systemic proportions. Policy options, however, are highly constrained by: a country’s initial conditions—including the initial level of public sector debt; fiscal policy headroom; the composition of domestic and foreign currency debt owed by private financial institutions and corporations; bargaining powers of, and relationships between, domestic debtors and domestic and foreign creditors; and the government’s relations with foreign creditors. In general, policies that restore the country’s credibility should be pursued. Strategies for crisis management include both international and national responses. International responses include the provision of international liquidity from outside—such as through the IMF—and internationally coordinated private sector involvement. National responses include appropriate monetary and fiscal policy and possible involuntary private sector involvement—or unilateral standstills or capital outflow controls.

Lesson 4: Mobilize timely external liquidity of sufficient magnitude in a context of sound policies to restore market confidence.

In the face of a crisis, whether induced by fundamentals or nonfundamental herd behavior, governments have no choice but swiftly to seek liquidity to staunch a run on its domestic assets. The availability of large amounts of liquidity rapidly to head off currency crises is an obvious benefit if they most likely result from irrational herd behavior. This liquidity usually comes from the IMF. Given the recent magnitude of capital outflows, governments of crisis-affected countries could be faulted for not recognizing the seriousness of the crisis or not moving rapidly to bring in the IMF.

International interventions, however, have received criticisms from two different camps. One camp of critics, who argue that the IMF should play an international lender of last resort function, insists that the amount of international liquidity provided so far has been too small and often too late to contain a crisis or contagion. According to this view, to prevent a liquidity crisis from evolving into a serious solvency crisis, international liquidity must be provided quickly and abundantly. Another camp of critics, who argue that IMF interventions create moral hazard problems, insists that the rescue packages may create perverse incentives that heighten risk of crisis: for governments to run excessively risky policies and for international investors to underestimate the true risk of investing in emerging markets [Krugman, 1998]. To minimize potential moral hazard, IMF interventions should be contingent upon

considerable adjustment efforts on the part of the crisis country as well as appropriate burden sharing on the part of international investors.⁹ The latter, whose participation is called “private sector involvement,” forces international investors to share the costs as a penalty for imprudent risk taking.

Pitfalls. Though intellectual support for transforming the IMF into a genuine international lender of last resort is strong (provided that the potential for moral hazard is minimized), the G-7 countries have found it impractical and unrealistic due to the need to increase dramatically the amount of resources available in times of crises and contagion. The international community instead has taken an incrementalist approach to liquidity enhancement through the creation of the Supplemental Reserve Facility (SRF) and the Contingent Credit Line (CCL). Nonetheless, no country has decided to use the IMF CCL, as there is clearly an incentive compatibility problem. As long as the CCL is a voluntary arrangement, no country would be interested in agreeing to the CCL because of the fear of being perceived as “problematic.” If the CCL is made into a mandatory arrangement for all emerging market economies—as deposit insurance is for all commercial banks—then many economies would wish to be certified by the IMF as “good” and, hence, eligible for CCL arrangements. However, some economies would inevitably fail to be certified as “good.” Economies that are initially certified as “good” may also slip to a “bad” status at a later stage, which would send the signal that the country in question has serious problems. Since it is impossible for the IMF to require those “bad” economies to exit or to refrain from borrowing abroad—which is possible in the case of “bad” commercial banks because the regulator can take away the bank licenses—these potentially “bad” economies would certainly object to the introduction of the CCL.

Lesson 5: There is no one-size-fits-all prescription for monetary and fiscal policy in response to crises.

The conduct of monetary and fiscal policy had been at the center of the policy debate during the early phase of the East Asian crisis. The debate focused on whether contractionary monetary and fiscal policies could stabilize financial markets or precipitate a collapse in output and financial markets.

Monetary Policy: “Your money or Your Banks.” Contractionary monetary policy raises interest rates on domestic currency denominated assets and increases the cost of speculation, thereby discouraging capital outflows or encouraging inflows. Moreover, a contractionary monetary policy is a signal to markets of the government’s willingness to defend the exchange rate. This creates a dilemma, however. High interest rates debilitate a weak banking sector and increase the cost of borrowing and debt servicing for indebted corporations.¹⁰

The evidence provides mixed results in the policy debate—see, for example, Kaminsky and Schmukler [1999], Baig and Goldfajn [2002], and Kraay [2003]. In economies with heavily leveraged corporations and weak banks, tight monetary policy encounters a severe trade-off between maintaining the value of currencies and maintaining the solvency of the real and financial sectors. If corporations are highly indebted in

domestic currency, as was the case with Korea, a high interest rate is detrimental to the corporate sector. If corporations are highly indebted in foreign currency, as was the case with Indonesia, currency depreciation is detrimental to corporate health. A high interest rate policy that attempts to support the exchange rate makes sense, therefore, if the country's external debt is high and domestic debt is low, and vice versa. Governments in East Asia under these circumstances vacillated between tightening monetary conditions to protect the exchange rate at the cost of impending systemic bankruptcies and providing liquidity to banks that were stressed at the cost of plummeting exchange rates and inflationary surges.¹¹

Fiscal Policy: "Can You Finance It?" Supporters of tight government budgets argue that this generates credibility by signaling to investors a willingness to control inflation, facilitate current account adjustment (through contractionary impacts), and mobilize public resources for financial sector restructuring—to cover any new debt burden that may result from deposit guarantees, bank recapitalization, and assumption of other financial sector liabilities. Others argue that tight fiscal policy aggravates the crisis by further reducing aggregate demand in addition to the effects of the devaluation that usually accompany crises. Reducing net public spending thus intensifies the vulnerabilities of the banking and corporate sectors, worsening the emerging crisis.¹²

The appropriate policy stance depends on three factors: the cause of the crisis, the fiscal headroom available before the crisis, and the willingness of the private sector to finance government deficits. When the crisis country has a favorable fiscal position in the pre-crisis period—low public sector debt and hence credible headroom for fiscal policy, as well as large domestic savings that can be tapped to finance a budget deficit—the government has the luxury of a more expansive fiscal policy to support aggregate demand and to provide leeway to vulnerable banks. Contractionary fiscal policy makes sense if the cause of the crisis is government overspending and if the economy's activity level is not severely damaged. When the government has little domestic fiscal headroom or faces constraints to external financing on market terms, the country can still have some access to resources from the multilateral development banks (MDBs)—such as the World Bank, the Asian Development Bank, and the Inter-American Development Bank.¹³

Pitfalls. Perhaps the major drawback of this lesson is that the disagreement about which policies to pursue increases in the midst of crises, making it difficult to implement the right policies promptly and leading to trials and errors that can be costly. Moreover, pursuing economic adjustments at times of crises can be politically and socially costly. Finally, the arguments above collectively suggest that the best mix of monetary, exchange rate, fiscal, and debt policies depends on the structure of public and private debt, the degree of external support, and, most importantly, domestic politics [Haggard, 2000]. No single, painless policy will quickly restore investor confidence.

Lesson 6: Bailing-in private international creditors at times of crisis is essential. In those cases when official resources are limited relative to the magnitude of the crisis and private creditors are not amenable to coordination, some involuntary private sector involvement may be necessary.

When IMF liquidity support is provided in response to a crisis, it is essential to involve private international creditors by encouraging them to agree on a “standstill,” which entails a suspension of payments on external debt and a debt restructuring negotiation that may eventually lead to rollover, extension of maturities, and interest or debt reductions. In the case of commercial bank loans, coordination between a limited number of international creditor banks and domestic debtor banks can relatively easily result in an agreement on temporary standstills on repayments.¹⁴

Official standstill provisions in the form of a temporary suspension of debt payments can constitute an integral part of crisis management [World Bank, 1998a]. This procedure functions as a floodgate that helps stop the decline in the currency value and enables the authorities to buy time to put in place a credible adjustment program and to organize creditor-debtor negotiations. If combined with appropriate, early debt workout agreements, this arrangement could result in better outcomes for both the debtor economy and the creditors.

To facilitate sovereign debt resolution, two approaches have been proposed: the contractual approach and the statutory approach. The contractual approach suggests the inclusion of collective action clauses in sovereign bond contracts so as to allow quick and orderly processes of bond restructuring in the event of insolvency. The statutory approach, notably the “sovereign debt restructuring mechanism” proposed by Krueger [2002], requires legal changes or treaties to allow all types of sovereign debt to be resolved in the event of a debt sustainability crisis. Some important progress has been made in the area of collective action clauses. This practice needs to go beyond sovereign bonds and cover private debt because of the rising importance of private-to-private investment, as was the case in Asia.

Pitfalls. Bailing-in the private sector is not always easy. First, in the case of emerging economy bonds, agreeing on standstills in the event of emergencies would be more difficult because of the large number of bondholders involved and their dispersion. This difficulty is real because most of the financial flows to emerging markets now take the form of bond issues. For such bonds, developing collective action clauses or debt restructuring mechanisms would obligate bondholders to accept rules of the game—including standstills, rollovers, and restructuring—because they enhance the predictability and the pace of debt restructuring in the event of a crisis. Still, agreement on these mechanisms is not easy to achieve across market participants in different parts of the world. A second difficulty of bailing-in is that it may be hard to adopt a rules-based system because of the specific nature of country and market circumstances. Until international bankruptcy procedures are put in place, official debt standstills had better be invoked on a case-by-case basis.

RESOLVING THE SYSTEMIC CONSEQUENCES OF CRISES

The final focus of policy makers should be on strengthening crisis resolution mechanisms that would create conditions for early resolution of the systemic consequences of a crisis and initiation and acceleration of the recovery process. Such mechanisms include the establishment of frameworks for dealing with nonviable banks and non-bank financial institutions (NBFIs), the strengthening of domestic corporate insolvency procedures, the development of international debt-restructuring arrangements—as mentioned in Lesson 6—and the improvement of the social safety net. The basic frameworks of these mechanisms need to be put in place before a systemic crisis occurs, that is, at normal times, rather than at times of a crisis, because their designing and development take time.

Lesson 7: Move swiftly to establish domestic and international resolution mechanisms for impaired assets and liabilities of nonviable banks and corporations.

First, domestic procedures of banking sector resolution were often inadequate in East Asia. Resolution of weak banks and NBFIs should involve the following procedures: diagnostic reviews of bank portfolios that are based on internationally accepted classification rules and accounting principles; identification of viable and nonviable banks; resolution of nonviable banks—through liquidation, closure, temporary nationalization, or merger and acquisition—with a view to protecting depositors and viable corporate borrowers; establishment of official asset management companies (AMCs) to carve out nonperforming loans (NPLs) from weak or closed financial institutions; and recapitalization of viable banks after full provisioning and reevaluation of NPLs at fair market prices and realistic recovery rates. Emerging market economies must introduce such resolution procedures so as to resolve effectively the systemic impacts of a crisis and to accelerate the recovery process. These procedures should keep a medium-term objective of restoring healthy financial and corporate sectors, within a long-term version of reforming the financial and corporate structures.

Second, in East Asia domestic insolvency procedures of corporations were also inadequate for private creditors and debtors to reach agreements. Insolvency procedures include: the establishment of effective bankruptcy; reorganization and foreclosure laws for creditors wishing to take legal action to recover assets; creation of enabling environments for corporate restructuring; the introduction of “London rules” types of voluntary out-of-court frameworks for corporate restructuring; and the empowerment of the official AMCs to dispose of and restructure the acquired assets and/or debtor corporations. Enabling environments tend to provide creditors and debtors with sufficient incentives (sticks and carrots) to implement voluntary workout through either of two methods: eliminating legal, tax, and regulatory impediments to corporate restructuring, or introducing tax or other incentives for it. The presence of deep capital markets is also helpful in facilitating corporate restructuring through securitization of corporate assets and price discovery in the market.

Finally, internationally supported arrangements for orderly debt workout must be developed to facilitate efficient external-debt restructuring in the event that debtors

become insolvent or cannot meet debt-servicing obligations to their creditors. These arrangements are designed to enable debtors and creditors to share the costs of crisis resolution, rather than leaving borrowers with all of the consequences, and would take the form of a contractual or a statutory approach as described in Lesson 6. Though usually costly and time consuming, these procedures are critical institutional mechanisms to avoid more costly solutions and would become truly effective if extended from sovereign to private debt. The East Asian experience shows that, as long as a country's external debt, particularly private corporate debt, is not resolved, its banking sector remains unprofitable and economic stagnation tends to be prolonged.

Pitfalls. The drawback with these lessons is that the mechanisms mentioned above should be established before crises happen. Experience shows that these mechanisms are rarely set up *ex ante*, as the incentives are not present to prepare for bad times. Once a crisis erupts, liquidation of banks and corporations tends to be delayed, because of the difficulty of disentangling liquidity from solvency crises. Also, at that time, it is hard to establish those resolution mechanisms, as authorities are focused on managing short-run problems.

Even introducing such mechanisms *ex ante* would not be easy. They would certainly require financial, accounting, legal, and judiciary expertise, which is lacking in most emerging market economies. Strong enforcement of laws through the judiciary process and the presence of effective regulatory and supervisory frameworks would demand such expertise. Governments would have to pay lucrative salaries to judges and to other public officers overseeing the regulatory and supervisory frameworks in order to attract highly competent experts and to avoid corruption.

Lesson 8: Cushion the effects of crises on low-income groups through social policies to ameliorate the inevitable social tensions associated with adjustment.

The disruption and enormous social costs witnessed in the aftermath of economic crises have highlighted the need to address the social vulnerability exposed by crises. Without such attention, a crisis would be accompanied by excessively large adjustment costs, especially for the poor and the vulnerable segments of society, with long-term and often irreversible impacts, such as the destruction of human capital, social institutions, and political stability. Reduction of social costs and an increase in resilience to crisis require a broad approach in developing countries, spanning from the creation of market insurance against job or income losses—for example, unemployment insurance and protections to individual savings of the poor—to self-protection against becoming poor—for example, health maintenance and increased education [de Ferranti et al., 2000; World Bank, 2000c]. The most important step that each developing country can take is to establish an institutional framework to minimize the risks and severity of economic downturns at times of crises, and then respond to the particular needs of the poor during crises.

Policies include: collecting better information about the poor and their exposure to economic risk; targeting of scarce fiscal subsidies on programs for the poor, especially during crises; improving evaluation of spending programs to ensure a positive

pro-poor focus, particularly in health and education; and establishing automatic programs—such as unemployment insurance or stay-in-school programs—which provide more predictable institutional responses to economic downturn, regardless of cause.

These policies can be financed typically through loans made by the MDBs, such as the World Bank, the Asian Development Bank and the Inter-American Development Bank, and by bilateral donor countries—like the New Miyazawa Initiative that was extended to cover fiscal needs for crisis resolution during the Asian crisis.

Pitfalls. During crises it is often difficult to give social policies the priority they deserve because budgets tend to be under pressure. Moreover, loans by the regional and MDBs to social programs during crises tend to be tied to IMF conditionality, and it typically takes time for countries to reach an agreement with the IMF, which hampers disbursements in these programs. Even when early disbursements are possible, the lack of reliable institutions that effectively manage and oversee social spending can reduce the impact of any program.

REGIONAL AND GLOBAL FRAMEWORK

Although most attention has focused on global and domestic policy reforms, developing an effective regional framework can help complement a new international financial architecture and strengthen domestic policy reforms. This is particularly the case when economies in a region are interdependent in trade, FDI, financial flows, and macroeconomic activity, as they are in East Asia.

Lesson 9: Improve mechanisms for crisis prevention, management, and resolution at the regional level in a way consistent with improvements in the global framework.

Because economic contagions tend to begin within a particular geographical area, a regional framework for financial coordination to address crisis prevention, management, and resolution is logical. An efficient cooperative framework for regional financial management can be designed to cope with currency crises, contagion, and simultaneous economic contraction.¹⁵ At the same time, such a regional framework must be consistent with a global framework in order to secure efficient responses to crises through proper financial management and crisis-resolution procedures. Because contagion can spread globally, this framework must be developed and international creditors from outside the region need to be involved, as well.

A framework for regional financial coordination may include four components: policy dialogue for regional economic surveillance and monitoring; schemes to augment international liquidity in times of crisis; monetary and exchange rate policy coordination; and programs to assist crisis-affected countries to resolve the systemic impact of the crisis and accelerate the recovery process.

First, regional policy dialogue for economic surveillance/monitoring is instrumental to crisis/contagion prevention. The process should encourage information exchanges on macroeconomic and structural issues, including fiscal, monetary, and exchange rate policies; capital flows; domestic and external debts; and financial sector conditions,

and promote “peer pressure” so as to induce good macroeconomic and structural policies that are conducive to stable external accounts and currencies. The East Asia region has established several such forums, including the Manila Framework Group, the ASEAN surveillance process, the ASEAN +3 Economic Review and Policy Dialogue (ERPD) process, and the Executives Meeting of East Asia-Pacific Central Banks [Kuroda and Kawai, 2003]. The most active among these is ASEAN+3 (ten ASEAN members plus China, Japan, and Korea), and its ERPD process focuses on regional surveillance that is intended to apply peer pressure for better policy making among the members.

Second, to contain the potential for regional contagion, avoid possible delays in disbursements of international liquidity in times of crises, and augment globally available resources, a regional financing facility can play a complementary role. Such a facility, however, needs to be designed to minimize moral hazard problems as well as to be consistent with a global framework in order to ensure policy coherence and exploit the synergy. The East Asia region has developed a network of currency swap arrangements under the Chiang Mai Initiative, which may be invoked to support a member currency that is under speculative attack, contagious impact, or in a crisis situation.

Third, for economies that are highly competitive or integrated with one another in trade, FDI, financial flows, and macroeconomic activity, intraregional exchange rate stability is a public good due to the spillover effects. Intraregional exchange rate stability requires the regional economies to develop greater exchange rate and monetary policy coordination. The East Asia region has been slow, however, in developing formal mechanisms to ensure intraregional exchange rate stability.

Fourth, in the face of a systemic crisis in the banking, corporate, and social sectors, mobilizing fiscal resources is essential to resolving the crisis quickly. Fiscal resources that are needed to recapitalize weak banks, facilitate corporate debt restructuring, and increase social safety net spending may be limited due to the lack of domestic fiscal headroom, lack of access to international capital markets, and lack of MDB resource availability. Regionally concerted action to mobilize such resources, therefore, particularly from the core countries in a region, would contribute greatly to crisis resolution if done consistently within global frameworks.¹⁶

Pitfalls. Setting up regional arrangements is not easy and has been opposed by some members of the international financial system. For example, an early attempt to set up an Asian Monetary Fund (AMF) was met by strong opposition from the United States and the IMF on grounds of perceived moral hazard and duplication. They argued that an East Asian country hit by a currency crisis could bypass the tough conditionality of the IMF and receive easy money from the AMF, thereby creating potential for moral hazard, and that an AMF would be redundant in the presence of an effective global crisis manager, the IMF.

Though the idea of creating an AMF was abandoned, it is becoming increasingly feasible. First, because of the high frequencies of emerging market crises, international liquidity needs have expanded while the capacity of the IMF to lend has not risen substantially. AMF resources can complement IMF resources. Second, regional economic interdependence has deepened significantly over the last decade, calling for

a need to ensure stable intraregional exchange rates, and thus an institutional mechanism for it. Third, East Asian economies are strengthening the regional surveillance mechanism through ASEAN+3, which is expected to augment the region's capacity to analyze the risks of regional economies, formulate adjustment policies in the event of crisis, and monitor the implementation of necessary policies. This could reduce the moral hazard problem associated with AMF lending to a crisis country. Fourth, the CMI may evolve into a more formal institution of reserve pooling. Fifth, potential borrowers may have incentives to participate in the regional surveillance and peer pressure process, because doing so would make them eligible to receive short-term liquidity at the time of currency and balance of payments difficulties. Finally, China, which was not supportive of the idea of creating an AMF in 1997, is now changing its stance.

CONCLUDING REMARKS

Financial crises in emerging market economies can originate either domestically or externally, and either from bad fundamentals or herd behavior. Crises associated with sharp reversals of capital flows are likely to be an enduring feature of the global financial landscape for some time to come. This article has summarized what we believe are the nine lessons from the East Asian crisis. If heeded by policy makers in developing countries, rich countries, and international financial institutions, these lessons could significantly reduce the frequency and damage from capital flow reversals and contagion. The paper has also highlighted the lack of incentives and difficulties in implementing these lessons, which might explain why some of these policies have not been adopted. Recognizing that adopting the prescriptions here is easier said than done, we believe the international community should study these issues in a systematic way, nonetheless, to better prepare for prevention, management, and resolution of future crises and contagion.

NOTES

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1. Several authors have written on the causes of the Asian crisis and the roots of the recovery, including Krugman [1998], World Bank [1998a, b], Eichengreen [1999], Hunter, Kaufman, and Krueger [1999], Radelet and Sachs [2000], Lindgren et al. [2000], Drysdale [2000], Ito [2001], and Yusuf [2003]. Some authors [Corsetti et al., 1999; International Monetary Fund (IMF), 1998a, b; Krugman, 1998; and Summers, 1999] have emphasized the fact that the East Asian countries financed unproductive investments because of implicit government guarantees and "crony capitalism." Such unproductive investment tended to weigh down long-term growth rates and hence generate vulnerabilities both in the real and financial sectors of the economies. At the same time, the governments accumulated large contingent liabilities because of the need to protect depositors of banks and other financial institutions. The strong trade linkages among these economies helped to propagate the crisis throughout the region. Others—such as Furman and Stiglitz [1998],

Radelet and Sachs [1998a, 2000], Krugman [1999], and Kaminsky, Lyons, and Schmukler [2004]—emphasize imperfections of the international financial markets as the major source of a crisis and contagion. Whether because of its fundamental weaknesses or out of self-fulfilling expectations, investors' panic transmitted the crisis to other markets, and decided to pull their investments out of these neighboring countries. In a world of self-fulfilling investor expectations, there exist multiple equilibria.

2. Investor sentiment and perceptions were undoubtedly the main driver of contagion. This appears to have two distinct elements. First, a common reaction to perceived problems and, second, a common fear—irrespective of individual agent judgments about the perceived problems—of what the herd of investors might do. In Korea, investors simultaneously came to note the risk of large short-term external debt, relative to foreign exchange reserves, and began to sell the won, while any individual investor could ignore the stampede only at his peril. In Indonesia, the collapse was also driven by investor panic. In this case, domestic investors were scared by the haphazard closure of the domestic banks and some news associated with President Soeharto's ill health. The politics of regime change added to the uncertainty in Korea, Indonesia, and Thailand and fed investor panic. Malaysia did not have large short-term external debt or a grossly weak banking sector (if perhaps somewhat overextended in real estate), and, without IMF financing, adopted macroeconomic policies that were akin to those under IMF programs—tight monetary and fiscal policies—at least until the spring of 1998. Beyond perceptions, the nature of bank finance also propagated the contagion. For example, a shock in one country induced international commercial banks to reduce exposure in other countries to protect the quality of their portfolios, thus propagating shocks and crises across countries. That some Japanese, European, and Korean banks, badly hit by the rupiah depreciation, were driven into distress or at minimum saw rapid deterioration in their portfolio quality, thereby reducing their bank exposure to the region, argues that they were possible channels of contagion [Kaminsky and Reinhart, 2000].
3. Much the same could be said for Argentina after 1998, when fiscal policy turned sporadically expansionary; the resulting larger borrowing led to higher debt ratios and subsequently higher costs of capital—as external conditions worsened—and these factors in turn offset any minimally short-run expansionary effects. See Perry and Servén [2002].
4. There is no one-size-fits-all solution. Though two corner solutions are not excluded, a more realistic approach would be what Goldstein [2002] calls “managed floating plus.” This is a combination of “managed floating,” that is, a system with occasional intervention to limit excessive short-term fluctuations in exchange rates without being accompanied by a publicly announced exchange rate target, and “plus,” that is, inflation targeting and aggressive measures to reduce currency mismatches. Measures to reduce currency mismatches include periodic announcements of the size of short-term external debt (as a ratio of foreign exchange reserves), development of deeper capital markets, and regulation on sovereign borrowing in foreign currencies. When a country has diversified economic—trade, investment, etc.—relationships with the U.S., Japan, and Europe, like those in East Asia, a system of using a basket of the U.S. dollar, the yen, and the euro, rather than a single international currency, as a reference currency might have some benefits over a simple peg. For more discussion on feasible exchange rate regimes see, among others, Frankel [1998], Frankel et al. [2001], Kawai [2002], and de la Torre et al. [2003].
5. As has been argued in the above, however, even more important was the unwillingness of the authorities to take early corrective action to adjust external imbalances when investor perceptions began to shift against local assets and capital inflows began to attenuate.
6. Chile had unremunerated reserve requirements in place from 1991 until September 1998.
7. In addition, countries with large foreign exchange reserves and access to contingent liquidity facilities will be able to inject liquidity in the system, avoiding credit squeeze and bank runs.
8. A corollary from Argentina is worth noting: ignoring lesson number one—which requires good macroeconomic policies—even if you obey lesson number two—which requires a strong banking sector—can spell disaster. After 1991, Argentina worked hard to improve its banks, their oversight, and the organization of the industry. By the eve of the crisis in 2000, they were widely regarded as among the best in Latin America and perhaps the developing world. Nonetheless, when the government managed poorly its response to severe external shocks, higher and unsustainable public borrowing eventually led to a run against the peso, a freezing of deposits, and eventually the abandonment of the currency board that caused a shock to bank balance sheets. Government policy in managing the devaluation aggravated the shocks by trying to push the

adjustment onto banks' capital. Poorly managed macro trumps well-managed financial sectors every time. See de la Torre et al. [2003].

9. Private debtors and creditors may expect that IMF financial interventions will reduce the risk of lending and borrowing. As long as IMF liquidity support is required at times of crises, therefore, private creditors and debtors should bear as fully as possible the consequences of the risks that they have voluntarily assumed. IMF interventions should not bail them out.
10. Radelet and Sachs [1998a, b], Furman and Stiglitz [1998], and Stiglitz [1999a], among others, discuss this point. Stiglitz [1999a], for example, argues that a high interest rate policy can cause capital outflows and exchange rate depreciation, instead of capital inflows and currency appreciation, when it increases the probability of bankruptcies in the presence of highly indebted corporations that have large domestic currency debt servicing obligations. This would weaken domestic banks' balance sheets because corporations are their major clients and, thus, induce capital outflows in an anticipation of eventual currency depreciation.
11. Some governments may be compelled to try to escape this dilemma by invoking unilateral standstills on external debt payments or thorough unorthodox policies that combine closing the capital account and fixing the exchange rate. Malaysia adopted the latter, unorthodox policies in September 1998, without being accompanied by unfavorable consequences, partly because the program was based upon conservative monetary and fiscal policies and its capital controls were short-lived. See Kawai and Takagi [2003].
12. See Radelet and Sachs [1998a, b]. Stiglitz [1999b] argues that fiscal contraction during an East Asian-type of crisis would be a beggar-thyself policy, which is worse than the beggar-thy-neighbor policy of the 1930s. Fiscal contraction causes recession in the domestic economy and, as a result, adversely affects the neighboring countries through trade linkages, which feeds back to the domestic economy and magnifies the extent of recession through multiplier effects.
13. Argentina provides another corollary that large official financing might not be enough unless government finances are in order. After 1997, the government did not reign in its fiscal deficit, but increased expenditures somewhat for political reasons in 1998 and early 1999, by borrowing abroad. As the economy continued to slide, however, the revenues slackened, the fiscal position worsened, and rising debt levels began to make markets nervous, thereby raising borrowing costs and worsening the cycle. In late 2000, the government approached the IMF for a new loan package with a proposal for a large but minimally increasing fiscal deficit. The IMF, having learned the virtues of Keynesian expansion in East Asia, offered to finance an even larger fiscal deficit, to which the government readily agreed. But the markets read the agreement as "no fiscal adjustment," and the risk premium rose rather than declined on fears that Argentina would not meet even these looser fiscal targets—which indeed they did not. The lesson here is that, when the cause of the crisis is a large fiscal deficit, fiscal headroom is already exhausted, and public debt is high and government credibility low, fiscal contraction cannot be avoided to bring confidence to the markets.
14. An example is Korea's external debt restructuring arrangement at the end of 1997 through the beginning of 1998. The Korean government, representing the interest of the country's commercial banks, agreed with international bank creditors on a standstill, during which period they negotiated to restructure external debt that was due shortly. The Korean government provided guarantees for debt payment, and the governments of major industrialized countries convinced their banks that the restructuring arrangements would be in their best interest. The restructuring agreement restored the confidence not only in the currency market but also in the financial system, providing a basis for the subsequent recovery.
15. Some countries generate more contagion effects than do other countries. Allocating resources to only one country in the midst of a regional crisis might not be very effective, because other neighboring countries may suffer contagion. Moreover, preventing and containing crises in the countries that generate more spillover is relatively more effective at controlling regional and global shocks.
16. An example is the so-called New Miyazawa Initiative, which was introduced in October 1998. Under this Initiative, Japan pledged US\$30 billion to support the economic recovery of the crisis-affected East Asian countries. Half of the pledged amount was to be dedicated to short-term capital needs during the process of implementing economic restructuring and reform, while the rest was earmarked for medium-term and long-term reforms. A commitment to provide a large amount of resources helped stabilize the regional markets and economies, thereby facilitating the recovery process.

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